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JAMES R. BROW

IN THE

Supreme Court of the United States

October Term, 1958.

No. 305.

GEORGE HUSS, RUSSELL HUSS AND WESLEY HUSS,
Petitioners,

v.

FRANCIS R. SMITH, Former Collector of Internal Revenue for the First District of Pennsylvania.

On Writ of Certiorari to the United States Court of Appeals for the Third Circuit.

REPLY BRIEF FOR PETITIONERS.

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THE CONCEPT OF "ECONOMIC ADVANTAGE" HAS NO APPLICATION TO THIS CASE; THE ECONOMIC INTEREST OF THE PETITIONERS IS CLEAR.

The Internal Revenue Code of 1939, whose provisions were in effect during the years for which the Petitioners seek tax deductions, expressly grants a taxpayer an allowance for depletion "in the case of coal mines, 5 per centum . . . . of the gross income from the property during the taxable year. . . . ." (53 Stat. 45, 26 U. S. C. 1952 Ed., § 114(b)(4)(A)).

And "gross income from the property" is defined as "the gross income *from mining*. The term 'mining' as used herein shall be considered to include not merely the *extraction of the ores or minerals from the ground* but also the ordinary treatment processes normally applied by mine owners *or operators* in order to obtain the commercially marketable mineral product or products." (53 Stat. 45, 26 U. S. C. 1952 Ed., § 114(b)(4)(B)). (Emphasis supplied.)

Beyond peradventure or doubt, the income of the petitioners came from and was entirely dependent upon one source: their mining or extraction of minerals from the ground. Their income was, therefore, "gross income from mining" within the plain language of the Code. Further, Petitioners' complete and exclusive control over the production of the coal conferred upon them the requisite interest in the mineral in place. *Burton-Sutton Oil Co. Inc. v. Commissioner*, 328 U. S. 25, 34 (1946). Thus, they have by natural qualification that "economic interest" which entitles them to the depletion allowance.

It is no answer to the case made out for the Petitioners to suggest, as respondent does, that the taxpayers were not entrepreneurs engaged in mining but employees rendering services under an employment contract. For purposes of entitlement to the depletion allowance, Petitioners' control of production contradicts this contention, and, for any purpose this theory is destroyed by the undisputed facts appearing in the record.

It was the Petitioners who alone decided when, where and how much to mine (R. 12; 31). It was the Petitioners who built the roads and the necessary buildings, and who invested over $500,000 in mining equipment (R. 31-32). It was the Petitioners who obtained all necessary mining permits (Ex. P. 1, R. 100; Ex. A, R. 141), who paid the appropriate taxes (Ex. P. 1, R. 99; Ex. A, R. 140), and who in fact, producing over 50,000 tons of coal a month (R. 14), mined the tracts to exhaustion (R. 35).

Certainly, in view of the Petitioners' negotiations with the United Mine Workers of America with respect to the terms and conditions of employment of the individual workers, the appellation of "employees" is singularly inappropriate (R. 7-9). By virtue of their exercise of complete control over production, their assumption of all risks in connection with the extraction of the coal and their independence in determining the nature and scope of their operations, Petitioners were entrepreneurs in the most literal sense of the word.

Equally, it is no answer to the case made out for Petitioners to suggest, as the Respondent does, that because the Petitioners' operations were pursuant to a writing executed by the parties, which purported to give the landowner power to terminate the Petitioners' interest in the coal on 30 days' notice, that such interest in the mineral never existed. But the basic error in the Respondent's argument is disclosed by the record itself; the power of termination was not, and was never intended to be, applicable to the Petitioners.

As Russell Huss testified, the Petitioners were much concerned about the termination clause contained in the contract prepared by the landowner. To use his words, "I didn't feel I wanted to move equipment on to a job and spend a certain amount of dollars moving it and find out after I had been there I would be put off in 30 days where I would not ever have a chance to get back the money I was investing" (R. 18).

Quite naturally he did not wish to expend funds and undertake obligations under such an apparent state of insecurity. However, representatives of the landowner assured him that the "provision was put in there in a form contract so as if they got hold of a contractor who was not reputable, they could put him off the property without court action" (R. 10).

The inescapable inference from this undisputed testimony is that the Petitioners, being reputable contractors, were not to be subject to unilateral cancellation by the landowner on thirty days notice. In fact, the intention of the parties was confirmed by their actions; in not a single instance did the landowner unilaterally terminate an agreement with the Petitioners (R. 11; 35). Each of the six contracts entered into with respect to the landowner's six coal tracts was terminated by mutual agreement (R. 35). Had the power to terminate been intended to apply to the Petitioners, there would have been no need whatsoever for the landowner to obtain Petitioners' consent to termination, especially when the coal tracts covered by the agreements had been mined to exhaustion (R. 35). The interpretation of these contracts by the parties themselves, as manifested in their conduct, is controlling.

Finally, it is no answer to the case made out for the Petitioners to suggest, as the Respondent does, that the interest of the Petitioners in the coal was "a mere economic advantage derived from production".

The concept of economic advantage was developed and applied by this Court some twenty years ago in the trilogy of *Helvering v. Bankline Oil Co.*, 303 U. S. 362 (1938); *Helvering v. O'Donnell*, 303 U. S. 370 (1938) and *Helvering v. Elbe Oil Land Co.*, 303 U. S. 372 (1938), to describe the interest of taxpayers who were denied the depletion allowance although their incomes were connected with the production of a mineral. In none of these cases did the taxpayer, a purchaser of gas (*Bankline*), a seller of stock in a corporation owning oil leases (*O'Donnell*), and a seller of oil land (*Elbe*), either produce, or possess a measure of

control over production of, the mineral. Whatever interests they possessed, therefore, were not interests in the mineral in place, and whatever incomes were obtained were not incomes from production of the mineral.

CONCLUSION.

The economic interest of the Petitioners is clear; the concept of "economic advantage" has no application to this case and therefore the judgments of the Court of Appeals should be reversed.

Respectfully submitted,

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SUPREME COURT OF THE UNITED STATES

Nos. 218 AND 305.—OCTOBER TERM, 1958.

Emory W. Parsons, Erma M. Parsons, Howard H. Parsons, et al, Petitioners,

218 v.

Francis R. Smith, Former Collector of Internal Revenue for the First District of Pennsylvania.

George Huss, Russell Huss and Wesley Huss, Retitioners,

305 v.

Francis R. Smith, Former Collector of Internal Revenue for the First District of Pennsylvania.

On Writs of Certiorari to the United States Court of Appeals for the Third Circuit.

[April 6, 1959.]

MR. JUSTICE WHITTAKER delivered the opinion of the Court.

These tax refund cases present the question whether petitioners, Parsons in No. 218 and Huss in No. 305, are entitled to an allowance for depletion on amounts received by them under contracts with the owners of coal-bearing lands for the strip mining of coal from those lands and the delivery of it to the landowners. The cases were heard by the same courts below. The District Court ruled that petitioners had no depletable interest in the coal in place and rendered judgment for the respondent—collector in each case. The Court of Appeals affirmed both judgments. 255 F. 2d 595, 599. Because of an asserted conflict with the principles applicable under the decisions of this Court, we granted certiorari in both cases. 358 U. S. 418.

The pertinent facts in each case were found by the District Court and are not challenged here. In substance, they are as follows:

PARSONS, No. 218. Petitioners were members of a partnership ("Parsons") which, until the transactions involved here, was primarily engaged in road building. Rockhill Coal Co. ("Rockhill") owned bituminous coal-bearing lands in Pennsylvania. Much of the coal was located relatively near the surface and was therefore removable by the strip mining process.[1] In 1942 Parsons expressed a desire to strip mine coal from Rockhill's lands, but it refused to sign the written contract offered because the firm did not wish to be bound by a contract "which would take a long time, since, if an opportunity opened up, [it] wanted to go back to road building." It was then agreed that Parsons would, and it did, proceed under an oral agreement. Under that agreement Parsons was to strip mine coal from such sites and seams, within a generally described area of Rockhill's lands, as were designated by Rockhill. Parsons was to furnish at its own expense all of the equipment, facilities and labor which it thought necessary to strip mine and deliver the coal to Rockhill's cars at a fixed point. For each ton of coal so mined and delivered Rockhill was to pay Parsons a stated amount of money.[2] Parsons was not authorized to keep or sell any of the coal but was required to deliver all that was mined to Rockhill. The agreement was not for a definite term, nor did it obligate Parsons to mine the tract to exhaustion, but, to the contrary, it was agreed that

[1] Strip mining is done from the surface of the earth. In general, it is performed by stripping off the earth, known as overburden, which lies over the coal and then removing the coal so uncovered.

[2] It was contemplated by the parties that in the event of an increase in the union labor wage scale the amount per ton to be paid to Parsons would be increased and on several occasions it was increased to cover higher costs for both labor and material used in the work.

"if Parsons or Rockhill wanted to quit, all that was necessary to terminate the arrangement was the giving of a ten-day notice." However, if Rockhill thus canceled the agreement and if "Parsons had previously gone to the expense of removing the overburden (thereby performing the heavy part of the work, as well as meeting wages and expenses in so doing), then Parsons would have the privilege of taking out the coal [so uncovered] and of being paid for it [even though] this took more than ten days." Operations continued under the agreement without notice of termination until August 1, 1950, when Parsons gave Rockhill notice that it would "quit" the work on September 1, 1950, and it ceased these operations on or near that date. Large amounts of strippable coal still remained on the tract and strip mining thereon was continued by another contractor. Parsons' investment in equipment used in the work ran from a low in 1943 of $60,000 to a high in 1947 of $250,000. The equipment was movable and there is no evidence that it was not usable elsewhere or for other purposes.

HUSS, No. 305. Petitioners were members of a partnership ("Huss") engaged in the business of strip mining coal. Philadelphia and Reading Coal & Iron Co. ("Reading") owned anthracite coal-bearing lands in Schuylkill County, Pennsylvania. Much of the coal was so located that it could be removed by strip mining. In 1944 Reading and Huss entered into a written contract [3] under which Huss undertook to strip mine the coal from such areas, within a generally described tract of Reading's land, as might be designated by Reading and that was not lying deeper than a prescribed distance from

[3] During the tax years involved, which were 1944 to 1947, other like contracts were entered into by the parties, but they were all identical, except for areas covered and prices per ton to be paid to Huss, and it will therefore be unnecessary to treat with them individually.

the surface. Huss was to furnish at its own expense all of the equipment, facilities and labor necessary to mine and deliver the coal to Reading's colliery. For each ton of coal so mined and delivered Reading was to pay Huss a stated sum.[4] That sum was agreed to be in "full compensation for the full performance of all work and for the furnishing of all material, labor, power, tools, machinery, implements and equipment required for the work." Huss was not authorized to keep or sell any of the coal. The contract was expressly terminable by Reading at any time upon 30 days' written notice "without specifying any reason therefor" and without liability for "any loss of anticipated profits or any other damages whatever." This right of termination was not exercised. Operations continued under the contract until July 1947, by which time Huss had mined most of the strippable coal on the lands covered by the contract that lay within the stipulated distance from the surface, and the contract was then canceled by mutual agreement. Huss' investment in equipment used in the work ran from a low in 1944 of $100,000 to a high in 1947 of $500,000. All of the equipment was movable and usable elsewhere in strip mining and some of it was usable for other purposes.

Whether a deduction from gross income shall be permitted for depletion of mineral deposits, or any interest therein, is entirely a matter of grace.[5] We therefore must look, first, to the provisions and purposes of the statutes and to the decisions construing them to see what interests are permitted a deduction for depletion, and, next, to the

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[4] The contract provided however that in the event of an increase in the union labor wage scale the amount per ton to be paid to Huss would be, and on several occasions during the operation it was, increased sufficiently to cover increased labor costs.

[5] *Helvering* v. *Bankline Oil Co.*, 303 U. S. 362, 366; *Anderson* v. *Helvering*, 310 U. S. 404, 408; *Commissioner* v. *Southwest Exploration Co.*, 350 U. S. 308, 312.

contracts involved to see whether they gave to petitioners such an interest.

The applicable statutes are §§ 23 (m) and 114 (b) (4) (A) of the Internal Revenue Code of 1939, 26 U. S. C. (1952 ed.) § 23 (m) and 26 U. S. C. (1946 ed.) § 114 (b) (4) (A). Section 23 (m) directs that a reasonable allowance for depletion shall be made "in the case of mines, . . . according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary," and that "[i]n the case of leases the deductions shall be equitably apportioned between the lessor and lessee." And § 114(b) (4) (A) provides that the allowance shall be, "in the case of coal mines, 5 percentum . . . of the gross income from [mining][6] the property during the taxable year, excluding . . . any rents or royalties paid or incurred by the taxpayer in respect of the property."

The purpose of the deduction for depletion is plain and has been many times declared by this Court. "[It] is permitted in recognition of the fact that the mineral deposits are wasting assets and is intended as compensation to the owner for the part used up in production." *Helvering* v. *Bankline Oil Co.*, 303 U. S. 362, 366. And see *United States* v. *Ludley*, 274 U. S. 295, 302; *Helvering* v. *Elbe Oil Land Development Co.*, 303 U. S. 372, 375; *Anderson* v. *Helvering*, 310 U. S. 404, 408; *Kirby Petroleum Co.* v. *Commissioner*, 326 U. S. 599, 603. "[The depletion] exclusion is designed to permit a recoupment of the owner's capital investment in the minerals so that when the minerals are exhausted, the owner's capital is unimpaired." *Commissioner* v. *Southwest Exploration*

[6] Section 114 (b) (4) (B) provided that "the term 'gross income from the property' means the gross income from mining." 26 U. S. C. (1946 ed.) § 114 (b) (4) (B).

Co., 350 U. S. 308, 312. Save for its application only to gross income from mineral deposits and standing timber, the purpose of "the deduction for depletion does not differ from the deduction for depreciation." *United States* v. *Ludley*, 274 U. S., at 303. In short, the purpose of the depletion deduction is to permit the owner of a capital interest in mineral in place to make a tax-free recovery of that depleting capital asset.

Although the sentence in § 23 (m) that "In the case of leases the deductions shall be equitably apportioned between the lessor and lessee" presupposes "that the deduction may be allowed in other cases" (*Palmer* v. *Bender*, 287 U. S. 551, 557), the statute "must be read in the light of the requirement of apportionment of a single depletion allowance" (*Helvering* v. *Twin Bell Oil Syndicate*, 293 U. S. 312, 321), for two or more persons "cannot be entitled to depletion on the same income" (*Commissioner* v. *Southwest Exploration Co.*, 350 U. S. 308, 309). It follows that if petitioners are entitled to a depletion allowance on the amounts earned under their contracts, the amounts allowable to the landowners for the depletion of their coal deposits would be correspondingly reduced.

Dealing specifically with the problem of what interests in mineral deposits were permitted a deduction for depletion under the practically identical predecessors of §§ 23 (m) and 114, this Court said in *Palmer* v. *Bender*, 287 U. S. 551, 557: "The language of the statute is broad enough to provide, at least, for every case in which the taxpayer has acquired, by investment, any interest in the oil in place, and secures, by any form of legal relationship, income derived from the extraction of the oil, to which he must look for a return of his capital." The Court further said that the deduction is not "dependent upon the particular legal form of the taxpayer's interest in the property to be depleted, [and that] [i]t is enough if . . .

he has retained a right to share in the oil produced. If so he has an *economic interest* in the oil, in place, which is depleted by production." [7] *Ibid.* (Emphasis added.) The Court went on to hold that lessees of oil producing properties, by reserving from an assignment a royalty of "one-eighth of all the oil produced and saved," retained

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[7] The principles declared in the *Palmer* case have been recognized and applied by every subsequent decision of this Court that has treated with the subject.

Helvering v. *Bankline Oil Co.*, 303 U. S. 362, 367, literally adopted the language of the *Palmer* case upon the point.

In *Helvering* v. *O'Donnell*, 303 U. S. 370, 371, it was said: "The question is whether respondent had an interest, that is, a capital investment, in the oil and gas in place . . . . *Palmer* v. *Bender*, 287 U. S. 551, 557; *Helvering* v. *Twin Bell Oil Syndicate*, 293 U. S. 312, 321; *Thomas* v. *Perkins*, 301 U. S. 655, 661; *Helvering* v. *Bankline Oil Co.*, *supra*."

Helvering v. *Elbe Oil Land Development Co.*, 303 U. S. 372, 375–376, declared that "The words 'gross income from the property' as used in the statute governing the allowance for depletion, mean gross income received from the operation of the oil and gas wells by one who has a capital investment therein,—not income from the sale of the oil and gas properties themselves."

Anderson v. *Helvering*, 310 U. S. 404, 408–409, repeated the statement last quoted.

In *Kirby Petroleum Co.* v. *Commissioner*, 326 U. S. 599, 603, the Court said: "The test of the right to depletion is whether the taxpayer has a capital investment in the oil in place which is necessarily reduced as the oil is extracted."

In *Burton-Sutton Oil Co.* v. *Commissioner*, 328 U. S. 25, 32, the Court said: "It seems generally accepted that it is the owner of a capital investment or economic interest in the oil in place who is entitled to the depletion."

Commissioner v. *Southwest Exploration Co.*, 350 U. S. 308, 313, reannounced substantially the rule declared in the *Palmer* case. It said "that a taxpayer is entitled to depletion where he has: (1) 'acquired, by investment, any interest in the oil in place,' and (2) secured by legal relationship 'income derived from the extraction of the oil, to which he must look for a return of his capital.' . . . These two factors, usually considered together, constitute the requirement of 'an economic interest.' "

an economic interest in the oil in place and were therefore entitled to an allowance for depletion against their gross income from that interest.

Five years later, in 1938, the Court in *Helvering* v. *Bankline Oil Co.*, 303 U. S. 362, reaffirmed the test laid down in *Palmer* and added: "But the phrase 'economic interest' is not to be taken as embracing a mere economic advantage derived from production, through a contractual relation to the owner, by one who has no capital investment in the mineral deposit." 303 U. S., at 367. Applying that principle, the Court held that a processor who, by contracts with the owners of gas and oil wells, had acquired the right to take wet gas from the well heads and to extract and sell the gasoline therefrom, paying the well owners a percentage of the proceeds of such sales, had not acquired an economic interest in the depleting gas in place but only an economic advantage to be derived from the processing operations, and that therefore the income from those operations was not subject to the depletion deduction.

In his first regulations prescribed under the Internal Revenue Act of 1939, the Commissioner adopted almost literally the language we have quoted from *Palmer* and *Bankline* as the tests to be administratively applied in determining what interests in mineral deposits are entitled to the depletion allowance. See Treas. Reg. 103, § 19.23 (m)–1, August 23, 1939. That language, with immaterial changes, has remained in the regulations ever since. During the years here involved, 1942 through 1950, the regulation in force was Treas. Reg. 111, § 29.23 (m)–1, which, in pertinent part, provides:

> "Under [the provisions of §§ 23 (m) and 114] the owner of an economic interest in mineral deposits or standing timber is allowed annual depletion deductions. An economic interest is possessed in every case in which the taxpayer has acquired, by invest-

ment, any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the severance and sale of the mineral or timber, to which he must look for a return of his capital. But a person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because, through a contractual relation to the owner, he possesses a mere economic advantage derived from production . . . ."

Such are the interests that are permitted a deduction for depletion by the statutes as consistently interpreted by this Court and by the Commissioner.

Petitioners do not dispute that these are the controlling principles, but rather they contend that they come within those that allow the deduction. They argue that by their contracts to mine the coal, and particularly by contributing their equipment, organizations and skills to the mining project as required by those contracts, they, in legal effect, made a capital investment in, and thereby acquired an economic interest in, the coal in place, which was depletable by production, and that they are therefore entitled to take the deduction against their gross income derived from those mining operations.

We take a different view. It stands admitted that before and apart from their contracts, petitioners had no investment or interest in the coal in place. Their asserted right to the deduction rests entirely upon their contracts. Is there anything in those contracts to indicate that petitioners made a capital investment in, or acquired an economic interest in, the coal in place, as distinguished from the acquisition of a mere economic advantage to be derived from their mining operations? We think it is quite plain that there is not.

By their contracts, which were completely terminable without cause on short notice, petitioners simply agreed

to provide the equipment and do the work required to strip mine coal from designated lands of the landowners and to deliver the coal to the latter at stated points, and in full consideration for performance of that undertaking the landowners were to pay to petitioners a fixed sum per ton. Surely those agreements do not show or suggest that petitioners actually made any capital investment in the coal in place, or that the landowners were to or actually did in any way surrender to petitioners any part of their capital interest in the coal in place. Petitioners do not factually assert otherwise. Their claim to the contrary is wholly based upon an asserted legal fiction. As stated, they claim that their contractual right to mine coal from the designated lands and the use of their equipment, organizations and skills in doing so, should be regarded as the making of a capital investment in, and the acquisition of an economic interest in, the coal in place. But that fiction cannot be indulged here, for it is negated by the facts.

To recapitulate, the asserted fiction is opposed to the facts (1) that petitioners' investments were in their equipment, all of which was movable—not in the coal in place; (2) that their investments in equipment were recoverable through depreciation—not depletion; (3) that the contracts were completely terminable without cause on short notice; (4) that the landowners did not agree to surrender and did not actually surrender to petitioners any capital interest in the coal in place; (5) that the coal at all times, even after it was mined, belonged entirely to the landowners, and that petitioners could not sell or keep any of it but were required to deliver all that they mined to the landowners; (6) that petitioners were not to have any part of the proceeds of the sale of the coal, but, on the contrary, they were to be paid a fixed sum for each ton mined and delivered, which was, as stated in *Huss*, agreed to be in "full compensation for the full perform-

ance of all work and for the furnishing of all [labor] and equipment required for the work"; and (7) that petitioners, thus, agreed to look only to the landowners for all sums to become due them under their contracts. The agreement of the landowners to pay a fixed sum per ton for mining and delivering the coal "was a personal covenant and did not purport to grant [petitioners] an interest in the [coal in place]." *Helvering* v. *O'Donnell*, 303 U. S. 370, 372. Surely these facts show that petitioners did not actually make any capital investment in, or acquire any economic interest in, the coal in place, and that they may not fictionally be regarded as having done so.

"Undoubtedly, [petitioners] through [their] contracts obtained an economic advantage from [their] production of the [coal], but that is not sufficient. The controlling fact is that [petitioners] had no interest in the [coal] in place." *Helvering* v. *Bankline Oil Co.*, 303 U. S., at 368. Of course, the parties might have provided in their contracts that petitioners would have some capital interest in the coal in place, but they did not do so—apparently by design. Instead, petitioners simply entered into contracts, terminable without cause on short notice, with the owners of coal-bearing lands to provide the equipment and do the work required to strip mine and deliver coal from those lands, as independent contractors, for fixed unit prices. "[Petitioners thus] bargained for and obtained an economic advantage from the [mining] operations but that advantage or profit did not constitute a depletable interest in the [coal] in place" (*Helvering* v. *O'Donnell*, 303 U. S., at 372), and having "no capital investment in the mineral deposit which suffered depletion, [petitioners are] not entitled to the statutory allowance" (*Helvering* v. *Bankline Oil Co.*, 303 U. S., at 368). The judgments must therefore be

Affirmed.